APPENDIX 1

MMS OIL ROYALTY VALUATION REGULATIONS

A. Overview

MMS' royalty valuation regulations were revised on March 1, 1988. The revised regulations operate only prospectively, covering value determinations for oil produced on or after March 1, 1988. 53 Fed. Reg. 1184 (Jan. 15, 1988). Thus, the team considered two different, but conceptually similar, regulatory schemes.

Prior to March 1, 1988, MMS's royalty valuation regulations were at 30 CFR § 206.103 for onshore leases and at 30 CFR § 206.150 for offshore leases. 30 CFR § 206.103 stated:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production . . . be less than the gross proceeds accruing to the lessee . . . or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, . . . paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, . . . produced and sold from the field or area where the leased lands are situated

will be considered to be a reasonable value.

30 CFR § 206.150 contained similar directives:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee . . . or less than the value computed on the reasonable unit value established by the Secretary.

30 CFR § 206.103 was promulgated in similar form in 1942 and 30 CFR § 206.150 was promulgated in similar form in 1954. The royalty valuation lease terms for both the standard onshore and offshore Federal oil and gas leases closely follow these regulations.

Neither these regulations nor the lease terms provide separate directives for valuation under arm's-length and non-arm's-length contracts. Both of these regulations set gross proceeds as minimum value and instruct MMS to consider posted prices as well as actual purchases and sales for oil produced from the same field or area in determining royalty value. Also, 30 CFR § 206.103 specifically relies on prices offered in "a fair and open market" for oil produced from the same field or area. Thus, in establishing royalty value, the regulations and lease terms emphasize the use of arm's-length contracts for oil produced from the same field or area as the oil being valued. Additional flexibility is imparted by including other relevant matters.

When MMS revised its regulations in 1988, it added more specific guidance for valuing oil not sold under arm's-length contracts. This is particularly relevant in California, because most oil is produced by integrated oil companies that "sell" it to their trading or refining affiliates or exchange it with third parties. Although the revised regulations maintained the principle that gross proceeds are minimum value for oil sold under both non-arm's-length and arm's-length contracts, they seemed to afford posted prices a more prominent role in valuing non-arm's-length sales. In valuing oil not sold under arm's-length contracts, the revised regulations continue to direct MMS to rely on arm's-length contracts for sales and purchases of oil produced from the same field or area as the oil being valued.

Specifically, on and after March 1, 1988, the present 30 CFR 206.102(b) provides that crude oil sold under an arm's-length contract will be valued at the gross proceeds accruing to the lessee under the contract. There is an exception if the contract does not reflect the total consideration actually transferred either directly or indirectly from the buyer to the seller. In that event, MMS has the option of requiring that value be established under the same "benchmarks" used for valuing oil not sold under arm's-length contracts, as discussed below. Value may not be less than the gross proceeds, including the additional consideration not reflected in the contract. 30 CFR § 206.102(b)(1)(ii). Furthermore, if MMS determines that the gross proceeds accruing to the lessee do not reflect the reasonable value of production due to misconduct or the lessee's failure to market the production for the mutual benefit of the lessor and lessee, MMS shall require that the production be valued under its benchmarks. 30 CFR § 206.102(b)(1)(iii).

If crude oil is not sold under an arm's-length contract, the present 30 CFR § 206.102(c) provides that value shall be determined according to the first applicable of a series of specific "benchmarks" listed in a prescribed order. The first benchmark is a key to the present analysis. It establishes value as:

> The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like quality oil in the same field . . . [or, if necessary, area]; provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field . . . [or, if necessary, area]. . . . If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume-weighted average price for the purchases or sales for the production month will be used.

This benchmark requires a dual "significant quantities" test. To use its own postings or oil sales contract prices for crude oil it sold at arm's-length as the value of crude oil not sold at arm's-length, the lessee's arm's-length sales and purchases must constitute "significant quantities" of like-quality crude in the same field or area. In addition, those arm's-length posted prices or oil sales contract prices must be comparable to other contemporaneous posted prices or oil sales contract prices for arm's-length purchases or sales in the same field or area, which also must be for "significant quantities." In other words, both the arm's-length postings or oil sales contract prices to be used as the measure of value and the arm's-length postings or sales to which they are comparable must be for "significant quantities." Finally, if there are multiple postings or oil sales contract prices for arm's-length transactions, then the lessee must use the volume-weighted average of those prices.

If the required elements of the first benchmark are not met, then the second benchmark would be applied. It uses the arithmetic average of posted prices used in arm's-length transactions by persons <u>other than</u> the lessee for purchases or sales of "significant quantities" in the same field (or, if necessary, area).

The third benchmark uses the arithmetic average of contemporaneous arm's-length contract prices for purchases or sales by persons <u>other than</u> the lessee for purchases or sales of "significant quantities" of like-quality oil in the same field or nearby areas.

The fourth benchmark uses arm's-length spot sales of "significant quantities" of like-quality oil in the same field (or, if necessary, area). It also includes other relevant matters.

Ultimately, if all the above benchmarks fail, then value may be determined according to a "net-back method or any other reasonable method to determine value."

Under the net-back method, costs of transportation, processing or manufacturing are deducted from the proceeds received for the specific oil being valued, or from the value of the oil at the first point at which reasonable values may be determined by an arm's-length sale or by comparison to other sales of such products. 30 CFR § 206.101. The preamble to MMS's revised regulations explains that this valuation method is to be used "primarily where the form of the lease product has changed." The net-back calculation is started "at the first point at which reasonable values for any product may be determined by a sale pursuant to an arm's-length contract or by comparison to other sales of such products." 53 Fed. Reg. 1196 (Jan. 15, 1988).

B. Significant Quantities

The regulations do not define the term "significant quantities." However, the proposed rulemaking provided some guidance as to the meaning of the term. The preamble to the proposed rule stated:

> The purpose of this phrase is to prevent abuses through application of unusually low or high postings under which little or no oil is actually purchased. The term "significant quantities" also is intended to be in relation to the volumes moving under typical purchases in the field or area. Thus, for a highly productive OCS field, to meet the significant quantities test, a larger volume would be required to be purchased under a posting than in a less productive onshore field. (Emphasis added.)

52 Fed. Reg. 1858, 1861 (Jan. 15, 1987).

Two relevant principles appear from this excerpt. First, the "significant quantities" tests are meant to ensure that the postings used as value are not at unreasonably low or high levels at which virtually no production is bought or sold. Second, although a larger volume of production must move under the postings for higher-producing leases, the preamble does not indicate that some higher percentage of production must move under the postings for more productive leases.

All of the "outright purchases and sales" -- *i.e.*, where there is not a reciprocal purchase or sale between the same parties that effectively results in an exchange -- constitute arm's-length transactions that would be included in the calculation of "significant quantities." The team's investigations indicate that perhaps as little as 20 percent or less of California-produced crude oil is sold under arm's-length outright purchases and sales contracts. Nevertheless, more than a "little" oil is sold at arm's-length. Thus, if MMS determines a monthly volume-weighted premium above posting for a field or area, it likely would meet the dual significant quantities test for that field or area and be used to value oil used internally or exchanged.

In addition, to the extent that buy/sell arrangements are treated as arm's-length sales, they must also be included for purposes of determining whether "significant quantities" are bought or sold at a particular posting or price. If exchanges of this type are counted, the effect would be to increase the quantity purchased or sold at a particular price, and therefore make it more likely that "significant quantities" are involved.

C. **Arm's-Length Contracts**

The arm's-length definition sets out a two-part test. For a contract to be at arm's-length, it must be (1) arrived at in the market place between independent, nonaffiliated persons (2) with opposing economic interests regarding that contract. 30 CFR § 206.101.

Clearly, outright sales of oil are at arm's-length. However, much of California production is disposed of under straight exchanges and buy/sell agreements. The team does not regard straight exchanges as arm's-length contracts. Additionally, the MMS Payor Handbook, Volume III, Part 3, treats straight exchanges as non-arm's-length contracts.

However, MMS regulations and the MMS Payor Handbook are not specific about whether buy/sell agreements are at arm's-length. Under buy/sell agreements, both parties sell oil to each other at a specific price or prices and invoice each other accordingly; usually, both transactions are linked in the companies' accounting systems. The substantive effect is to effectuate an exchange, possibly with a price differential.[1] Clearly, buy/sell exchanges between different, unrelated oil companies are between independent, nonaffiliated persons. However, there is a question as to whether the oil companies have opposing economic interests regarding that contract. If they do not, the contract is not at arm's-length. If it is not at arm's-length, it would be valued

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[1]A frequent reason for these transactions is that each party produces oil at a point much closer to the other's refinery.

under the benchmarks and would not be used in the determination of the volume-weighted average price under the first benchmark. It is the lessee's burden to demonstrate that its contract is arm's-length. 30 CFR § 206.102(b)(1)(i).[2]

The team reviewed several buy/sell contracts. This review suggests that:

- The contracts are done for the convenience of both parties. In other words, the parties do not have opposing economic interests.

- The reference to price is to establish a price differential between two crude oils rather than to establish the underlying price.

Therefore, the team does not believe that the contracts it reviewed are at arm's-length.

MMS' Payor Handbook, Volume III, Part 3, Paragraph 3.3, states that the value of oil for royalty purposes under buy/sell exchange agreements is based on whether the sale is arm's-length or non-arm's-length. In light of what we learned about buy/sells in the California market, the team believes that before MMS

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[2]Aside from the arm's-length question, it is not apparent that buy/sell exchanges could meet a reasonable definition of sale or purchase when the mutual intent often appears to be to gain locational advantage rather than outright disposition of the oil.

issues a bill to a specific company, it should examine several large buy/sell contracts for that company to determine if that company typically enters into arm's-length buy/sell contracts. That review will guide MMS in determining whether to treat that company's buy/sell contracts as arm's-length contracts. As discussed above, if MMS determines that a company's buy/sell contracts are arm's-length contracts and represent actual purchases or sales, those contracts would not be valued under the benchmarks. Furthermore, they would be included in the volume-weighted average price used to value non-arm's-length sales under the first benchmark.

An MMS Director's decision, Cities Service Oil and Gas Corp., MMS-86-0538-O&G, is instructional in determining whether to treat that company's buy/sell contracts as arm's-length contracts (see Appendix 2 for details on that decision).

D. **Obtaining a Marketing Arm's Records**

At about the same time the team was formed, the Interior Board of Land Appeals (IBLA) held that MMS was not entitled to look at the records of an integrated company's marketing arm. Shell Oil Co., 130 IBLA 93 (1994). In this case, MMS attempted to obtain Shell's marketing arm's records to determine if Shell paid royalties on its gross proceeds. The IBLA held that under 30 CFR § 206.102(b)(1)(i), MMS could not obtain such records unless the marketing arm was a marketing affiliate. The IBLA stated that Shell's marketing arm was not a marketing affiliate under MMS's regulations. The IBLA held that MMS should have valued production based on the non-arm's-length sale from Shell to its marketing arm. Such valuation should have been done under the above-discussed benchmarks.

MMS requested the IBLA to reconsider this decision. In Shell Oil Co. (On Reconsideration), 132 IBLA 354 (1995), the IBLA reversed its previous decision. It did so because MMS has statutory and regulatory authority to require the production of such documents to insure there has been compliance with its gross proceeds rule. This case is pending in U.S. District Court. Furthermore, in Santa Fe v. McCutcheon, No. 95-1221 (10th Cir. Apr. 10, 1996), the court held that MMS is entitled to such records to determine gross proceeds.

Until this litigation is concluded, MMS may be unable to obtain a marketing arm's records. However, this does not prevent MMS from issuing an order for such records. If the company refuses to provide such records pending litigation, MMS should value all sales from that company's production arm to its marketing arm based on other arm's-length sales. If MMS later determines that its bill did not reflect gross proceeds, it should then bill for any amounts due plus interest. The statute of limitations should not run for a specific company during any administrative or judicial litigation with that company when MMS is trying to obtain that company's marketing arm's records.

APPENDIX 2

DIRECTOR'S DECISION ON BUY/SELL EXCHANGES

A 1987 MMS Director's decision (MMS-86-0538-O&G) dealt with the issue of buy/sell exchanges. The appellant, Cities Service Oil and Gas Corporation (Cities Service), entered into a buy/sell oil exchange agreement. Cities Service sold oil it produced in North Dakota and then purchased a like volume from the same entity "in an area that can be either further traded or moved to the Lake Charles [Louisiana] refinery." The Director ruled that the Appellant did not make a simple sale to a third party that could presumptively establish value. Rather, the appellant put together an exchange agreement. Excerpts of the rationale follow:

> ...If the Appellant's purchaser has a refinery in North Dakota and oil wells in Louisiana, it is to both parties' benefit to exchange crude oil since both parties are able to save the transportation costs involved in transporting the crude oil from its wells to its refinery 1,500 miles away from its wells....
>
> ...In the simplest exchange the parties could exchange barrels of crude oil without even assigning a sales price to either the crude oil sent or crude oil received....
>
> ...the critical factor is that each party takes possession of crude oil at its refinery in exchange for giving up crude oil at its wells....even though the parties may exchange invoices, the prices assigned...may not be equivalent to the fair market value....The parties can assign prices that are half the market value as long as there is a reciprocal undervaluation on the crude oil sent as well as the crude oil received....In short, the price...even between unrelated

oil companies, is not necessarily the fair market value of the crude oil.

The Director concluded there was a conspicuous difference between the Appellant's invoice price and the crude's fair market value because there was a posted price that established the prima facia fair market value. The team notes that regardless whether the posted price or some other standard represents market value, this decision stands for the principle that the price in a buy/sell exchange does not necessarily represent market value. Thus, if a posting doesn't reflect market value, neither would the buy/sell invoice price tied to that posting.

These observations are significant in light of the fact that MMS' royalty valuation regulations rely on prices established by arm's-length sales.

APPENDIX 3

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 25165
Denver, Colorado 80225-0165

IN REPLY REFER TO
MMS-VSD-EVB
Mail Stop 3151

DEC - 6 1995

Memorandum

To: Assistant Secretary for Land and Minerals Management
Director, Minerals Management Service

From: Interagency Team Leader, California Oil Valuation Issue David A. Hubbard

Subject: Option list

As requested by the Director in our meeting of October 31, the team has developed the attached list of proposed options for addressing potential oil royalty underpayments in California. The list is not necessarily all-inclusive; there are many possible permutations.

Also attached are estimates of potential collections (royalty and interest) for the various options. Obviously there are many assumptions and qualifications attendant with these estimates; they are best used as a measure of relativity among the options.

Attachment

Attachment

Notes to Option List

1. The option list on the folowing pages contains estimated potential royalty and interest collections if the Federal Government were successful in applying the various options to the ten largest royalty payors. These companies make up about 90% of the California royalty volume for the years 1984 to 1993. (But for each option where dollar estimates are given, a certain amount may not be collectable due to the MMS/EXXON global settlement. Similar problems may exist for Chevron.)

2. Some of the options presented could be applied in combination with one another. For instance, Option VI might be applied where audit demonstrates premia on individual arm's-length sales at the lease level, and another option might be applied to the lessee's non-arm's-length transactions.

Option I. **California Crude Oil Valuation based on Alaskan North Slope (ANS) Crude Oil Market Prices**

DESCRIPTION

By using market prices for ANS crude oil delivered to Los Angeles, estimate the extent to which posted prices understate the California crude oil royalty prices MMS could have received. This approach, based on computations provided by Micronomics (one of MMS' consultants), would yield premia of about $2.85 per barrel offshore and $6.00 onshore in 1980, almost $3.00 for all production in 1984, and $1.00 to $1.40 for all production in the late 1980's and 1990's. The premia would apply to all Federal royalty volumes of the companies for whom MMS might pursue underpayments.

JUSTIFICATION

Under the pre-1988 regulations, this procedure might be justified as the "...reasonable value of the product determined by the Associate Director..." based on the highest price paid for a part or majority of like-quality field production, price received by the lessee, posted prices, regulated prices (offshore only) and other relevant matters.

Under the 1988 regulations, the justification would have to be that none of the first three Benchmarks are applicable for valuing non-arm's-length transfers of Federal lease crude oil. This would depend on two arguments:

- Exchanges (both pure exchanges and buy/sells) make up perhaps as much as 90% of overall trading, and are not contracts between companies with opposing economic interest. Therefore, they are not arms-length contracts for valuation purposes.
- The remaining outright purchases and sales amount to only a small portion of the overall volume traded, and are not sufficiently "significant" to employ as a basis for valuation.

Then royalty values might be established by applying "other relevant matters" (Benchmark (4)).

POTENTIAL REVENUE COLLECTION

Under the assumption that unpaid royalties on 90% of the onshore production and 100% of OCS production potentially would be collectable, estimated unpaid royalties and accrued interest would total $856 million for the period 1978 to 1993 inclusive.

Option II. **Apply Innovation & Information Consultants (IIC) Premia to All Royalty Production**

DESCRIPTION

This option would apply the average premia above posting estimated by IIC for Shell and Texaco (and validated in part by the interagency team) during the 1980's to most California royalty production. (Estimated premia for 1978-80 and 1989-1993 were extrapolated from these data.)

Premia were estimated using companies' purchase and sales contracts. The premia are lower then the method used in Option I because they don't capture as much of the refiners' margin as does the Option I methodology. For most years prior to 1986, premia are in the $1.00-$1.85 range; in 1986 and beyond, they are between $0.45 and $0.78 per barrel. The premia would apply to all Federal royalty volumes of the companies for whom MMS might pursue underpayments.

JUSTIFICATION

Under the pre-1988 regulations, this procedure might be justified as "... reasonable value of the product determined by the Associate Director..." based on the highest price paid for a part or majority of like-quality field production, price received by the lessee, posted prices, regulated prices (offshore only) and <u>other relevant matters</u>. In addition, it may be said to represent a value not less than the reasonable unit value determined by the Secretary, including the highest price paid for a part or majority of production.

Under the 1988 regulations, either Benchmark (3) or (4) might be cited as the valuation method. Benchmark (1), using the lessee's posted or contract prices, might be bypassed because relatively little production apparently is sold at arm's-length at posted prices. Benchmark (2) might be bypassed for the same reason and because the posted prices of persons other than the lessee apparently are used mostly in exchanges, which may not pass the competing economic interest test.

POTENTIAL REVENUE COLLECTION

Under the assumption that unpaid royalties on 90% of the onshore production and 100% of OCS production potentially would be collectable, estimated unpaid royalties and accrued interest would total $280 million for the period 1978 to 1993 inclusive.

Option III. Apply premia estimated by MMS audit to all volumes of Federal crude produced by large royalty payors.

DESCRIPTION

This method would apply the approach employed by MMS auditors to Texaco and Shell during this study. That is, booked crude oil costs would be subtracted from booked sales revenues with transportation costs disallowed. Using this procedure, MMS auditors calculated premia for 1989 of $0.89 per barrel.[1] If similar records are not available for other companies, the procedure would simply use contract premia applied to all federal royalty production. Using the latter method, MMS auditors found premia for Shell of $1.31 per barrel in 1984.

Depending on individual company circumstances and further audit, lessees might be permitted to demonstrate that actual transportation costs are associated with these premiums (allowing all transportation costs would reduce the $0.89 premium above to about $0.16). MMS would decide which costs are appropriate and thus how much the premia may be reduced.

JUSTIFICATION

Justifications for this approach would be similar to those discussed for Options 1 and 2 for periods before and after the 2/1/88 oil valuation rules were implemented. Further, the net revenues might be said to approximate the lessee's gross proceeds.

POTENTIAL REVENUE COLLECTION

Estimating potential revenues is difficult because the MMS audit work is not complete. Nor can one state with certainty how many of the companies would be assessed using contracts (per the procedure for Shell) or by the crude cost and sales revenue method (as for Texaco). If the premium derived for Shell ($1.31/bbl) is applied before 1986 and the Texaco premium of $0.89 is applied thereafter, collection estimates are $316 million.[2] Of that amount, $97 million is estimated using the

[1] In addition to outright purchases and sales, buy/sell exchanges, most of which were simply employed to transport oil for others, were used as valid transactions for royalty valuation purposes in estimating this premium.

[2] January 1, 1986, is used as the"break" point because a dramatic, long-term drop in crude oil prices occurred about that time.

booked cost and revenue methodology applied by the MMS auditors to Texaco's transactions. If all transportation costs are allowable, the premium drops to $17 million. The total would then be $236 million for this option; however, most of that estimate is derived using contract data just as in Option II.

Option IV. **Assume that some fixed percentage of Federal production is sold at a premium and apply a selected premium to that volume.**

DESCRIPTION

MMS would assume that the lessee only received legitimate gross proceeds additions for some percentage of its production from Federal leases and apply a selected premium as in Option II or III to that volume. The percentage could be calculated, for example, by dividing the company's total sales and purchase volume at a premium by its total arm's-length transaction volume. (The latter could include all arm's-length outright sales/purchases, all arm's-length outright sales/purchases plus buy/sell exchanges, or all outright arm's-length sales/purchases plus all exchanges.) Selection of the denominator may depend on interpretations of which types of transactions are at arm's length, including "opposing economic interest" considerations. For example, buy/sell exchanges might not be considered to involve opposing economic interests.

The derived percentage could then be multiplied by (1) the selected premium and (2) production from each Federal lease to calculate royalties due by lease. The estimates provided here give a range based on data for Texaco and Shell applied to all the largest payors' Federal production.

JUSTIFICATION

The first valuation benchmark under the 1988 rules for oil not sold under arm's-length contract applies either the lessee's contemporaneous posted or contract prices for arm's-length purchases or sales of significant quantities of oil. If the lessee's arm's-length purchases/sales are at different postings or contract prices, then the volume-weighted average price for such transactions is to be used. Likewise, the third benchmark would apply the arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil. Thus if the lessee buys and sells significant quantities at arm's-length, it could be argued that the weighted average premium from these transactions could be applied to all of its non-arm's-length production. This option follows the same general logic.

Under the pre-1988 rules, this procedure might be justified as the reasonable value determined by the Associate Director, the highest price paid for a part or majority of production, or "other relevant matters."

POTENTIAL REVENUE COLLECTION

Four different cases are presented, all using Texaco's 1989 volume data to estimate the percent of production sold at a premium. The first and second estimates apply the IIC premia; the first considers all arm's-length sales and purchases plus exchanges in estimating the percentage of Federal production sold at a premium, and the second uses all arm's-length sales and purchases plus buy/sell exchange volumes. The third and fourth estimates apply premia from the MMS audits; the third considers all arm's-length sales and purchases plus all exchanges in estimating the percentage of Federal production sold at a premium, and the fourth uses all arm's-length sales and purchases plus buy/sell exchange volumes. Collection estimates range from $31.3 million for the first case to $83.2 million for the fourth.

Option V. Bill additional royalties only for specific volumes where MMS audit demonstrates third-party sales by lessee or its affiliate are at premium above posting--do company/lease apportionments based on field-level transactions.

DESCRIPTION

This approach would assess additional royalties where MMS audits show the lessee or the lessee's affiliate received premia above posting for specific field-level sales, but lease royalties for those fields were paid on postings. The allocation could involve, for example, the company's total field sales and purchases at a premium divided by its total field sales and purchases. This percentage could then be multiplied by (1) the weighted average premium and (2) production from each Federal lease in that field to calculate royalties due by lease. (For Texaco, because the numerous exchanges and complicated pipeline movements result in loss of identity of production, MMS auditors feel it would be difficult to discern specific field-level sales at premia and allocate them to specific Federal lease production. But this may not be the case for Shell or subsequent auditees where less complicated transactions occur.)

JUSTIFICATION

The MMS can make a case that premiums received by the lessee or its affiliates in specific sales represent gross proceeds to the lessee and should therefore represent royalty value.

POTENTIAL REVENUE COLLECTION

No dollar estimates can be provided until MMS audits demonstrate specific instances of sales at premia by field; any estimates would be speculative. Potential returns, however, likely would be somewhat less than those for Option IV., where a fixed percentage of Federal production is assumed to be sold at a premium.

Option VI. Bill additional royalties only for specific lease volumes where audit demonstrates third-party sales by lessee or its affiliate are at premium above posting.

DESCRIPTION

This approach would assess additional royalties where MMS audits show the lessee or the lessee's affiliate received premia above posting for specific sales traceable directly to the lease, but royalties were paid on postings. (For Texaco, because the numerous exchanges and complicated pipeline movements result in loss of identity of production, MMS auditors feel it would be difficult or impossible to assign sales at premia to specific Federal lease production. But this may not be the case for Shell or subsequent auditees where less complicated transactions occur.)

JUSTIFICATION

The MMS can make a case that any premiums received by a lessee or its affiliates in specific sales represent gross proceeds to the lessee and should therefore represent royalty value.

POTENTIAL REVENUE COLLECTION

No dollar estimates can be provided until MMS audits demonstrate specific instances of sales at premia by lease; any estimates would be speculative. The returns, however, likely would be somewhat less than those under Option V., where "premia" sales at the field level would be allocated to Federal lease production rather than establishing a direct link between specific contracts and leases.

Option VII. **No attempt to collect additional royalties for past periods; instead, revise the MMS oil valuation rules.**

DESCRIPTION

MMS would not try to collect additional royalties for past periods in California. Rather, it would pursue revising its oil valuation rules for prospective application. (It is assumed that regardless of the option chosen, MMS will actively pursue revising the rules.)

JUSTIFICATION

MMS would have to decide that the current rules don't provide enough flexibility to attempt to collect additional royalties.

POTENTIAL REVENUE COLLECTION

No additional royalty collections would result until the regulations were revised, and then only prospectively.